The State of the Soviet Economy and the Role of East-West Trade

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Overview

As the Soviet Union completes the first year of its new five-year plan, the economy has turned sour before the long anticipated labor and energy problems have come into play. Three bad harvests have left agriculture in disarray. Meanwhile, transportation and material bottlenecks and smaller productivity gains have reduced industrial growth sharply. Because prospects for raising productivity are poor, GNP growth may well be limited to 1-2 percent on average by the mid-1980s.

Slower economic growth will present President Brezhnev and his colleagues with some increasingly tough and politically painful choices regarding resource allocation and economic management. Annual increments to national output in the early 1980s will be too small to permit them simultaneously to increase investment, maintain growth in defense spending at rates of the past, and raise the standard of living. Simply stated, something will have to give.

Given their problems, the Soviet need for Western goods and credits will increase greatly. Western imports would help planners deal with the basic problems confronting the Soviet economy during the 1980s--declining productivity and resource stringencies. Imports of Western plant and equipment, though now only about 5 percent of total domestic investment, make a disproportionately large contribution since their productivity is substantially higher than Soviet-designed equipment. Large food imports will be required to maintain consumer morale and encourage labor productivity during the 1980s.

Soviet leaders, however, would be very unlikely to change their foreign policy to ward off the threat of a western economic embargo. They do not believe such a course would be economically necessary or politically feasible. While a denial limited to US-origin equipment and technology would be disruptive in the short term, other Western and some East European equipment and technology would be adequate substitutes. Only if the USSR were denied access to most Western equipment and technology for an extended period would the Soviet economy suffer substantial damage. Politically, changing Soviet foreign policy to get Western goods would be viewed as appeasement and would undermine the position of anyone who might recommend it.

The Current State of the Soviet Economy

As the Soviet Union completes the first year of its new five year plan, the economy has turned sour before the long anticipated labor and energy problems have come into play. After averaging close to 4 percent during most of the 1970s, CIA measures of the average annual rate of GNP growth fell to just 1 percent during 1979-80. Only a weak rebound is expected this year.

Agriculture

Agriculture has been Moscow's biggest headache. The Soviets have now suffered their third straight harvest failure. We estimate that the grain crop will be about 170 million tons, 19 million tons less than last year's poor crop. Because meat production and the output of most other crops are expected to exceed last year's depressed level, however, total farm output should increase slightly compared with last year. Nevertheless, output will still fall short of the 1976 level.

While the odds are that the weather will be better next year, a return in the coming decade to the unusually favorable weather patterns that existed from the mid-60s to the mid-70s seems unlikely. Rather, the somewhat harsher conditions that prevailed for 20 years prior to the mid-60s are likely to be the rule. In this environment, the gains in agricultural output that accrued between the mid-60s and mid-70s--largely the result of good weather--will be nearly impossible to achieve in the 1980s ~~unless there is a sharp reversal of current trends in the~~ delivery of machinery ~~and~~ fertilizer to agriculture.

Industry

While agriculture has grabbed most of the headlines, industry also has been doing poorly. More than halfway through 1981, growth in almost every major sector is running behind the pace of a year ago. Civilian industrial output grew by less than

2 1/2 percent in first-half 1981 compared with first-half 1980. In the postwar period, only the 1979 first-half showing was worse.

Lagging output of industrial materials is a major reason for the economy's malaise. An abrupt slowdown in the growth of the steel and construction materials sectors (Table 1) has had a decided effect on new fixed investment, while shortages of nonferrous materials, lumber, and paper have become increasingly evident.

Growth of Soviet energy production also has slowed. After averaging almost 5 percent during most of the 1970s, primary energy production should fall to less than 3 percent this year. Oil output has been almost stagnant for the past year, while coal output--which peaked at 724 million tons in 1978--will probably decline to 710 million tons this year. Only gas continues to do well; the USSR should have little trouble in reaching its 1981 production goal of 16.2 trillion feet. Meanwhile, spot fuel shortages have become more frequent, reflecting a tighter supply situation as well as distribution problems. Although the Soviets are stepping up their efforts to increase the efficiency of energy use in the economy, campaigns of this kind in the past have fallen far short of their targets.

The machinery sector--the foundation of the USSR's military and civilian investment programs--has performed better than any

Table 1

USSR: Average Annual Percentage Rates of Growth of Industrial Production

	1961-65	1965-70	1971-75	1976-80
Total Industry	6.6	6.3	5.9	3.4
Industrial Materials	6.8	5.8	5.4	2.6
Ferrous metals	7.2	5.1	4.0	1.1
Nonferrous metals	7.6	7.4	5.9	2.6
Chemicals	12.0	8.9	8.6	3.9
Construction materials	5.4	5.7	5.4	1.8
Wood, pulp, and paper	2.6	2.9	2.6	0
Fuels	6.3	5.0	5.0	3.3
Electric power	11.5	7.9	7.0	4.5
Machinery	[illegible]	6.9	7.0	5.4
Civilian	8.9	8.2	9.0	5.8
Military	4.1	3.6	4.5	3.4
Consumer Nondurables	4.8	6.4	3.4	1.6
Light industry	2.6	7.2	2.7	0.7
Processed foods	6.8	5.9	3.9	0.7

sector of industry in the past several years. But even the growth of civilian machinery output--after increasing at about 6 1/2 percent per year in 1976-79--fell off to a rate of less than 4 percent per year in 1980.

Underlying the economy's poor showing is the continuing slowdown in the growth of labor productivity. Productivity in industry, for example, during the first six months grew at an annual rate of less than 1 1/2 percent--almost one-third less than in 1979-80 and far below the 4 1/2 percent average targeted for the 1981-85 plan.

Output and Productivity in Soviet Industry
(average annual percentage change)

	1951-60	1961-70	1971-75	1976-80
Output	9.2	6.4	5.9	3.4
Manhours worked	2.6	3.0	1.5	1.6
Labor productivity	6.4	3.3	4.4	1.8

The rising cost of exploiting raw materials explains part of the slower growth of industrial productivity. The quality of mineral deposits has declined in many instances, and minerals, energy, and timber must be obtained from remote areas, notably Western Siberia. Declining rates of growth of investment in the economy generally have also affected industry. Whereas fixed capital in industry increased by 11-12 percent per year in 1951-65, this growth dropped to 7 1/2 percent per year in 1976-80.

Meanwhile, shortages of basic materials, such as steel and cement, have become much more serious in recent years, creating bottlenecks throughout the economy and disrupting and, in some cases, halting construction activity and industrial operations. Soviet planners, in trying to provide for the rising investment requirements of defense industry, agriculture, and energy seem to have shortchanged some branches producing critical industrial materials. Economic plans were made consistent on paper only by decreeing unrealistically large efficiency gains in these lower-priority sectors.

Capital Formation

Soviet planners--like their counterparts in other Warsaw Pact countries--have apparently singled out fixed capital investment to bear the brunt of dealing with tightening economic constraints. Fixed investment in 1981-85 is slated to grow at an average annual rate of only 2.4 percent. Indeed, there have been recent indications that already modest investment plans are undergoing further cuts. Historically, investment has increased more rapidly--7 percent per year in 1966-75 and 3 1/2 percent annually in 1976-80.

The investment slowdown will affect most parts of the economy. In particular, bottleneck sectors needing more investment like steel, transportation, and civilian machine building are not likely to receive nearly as much as they require. Only energy is slated for a sharp rise in investment funding while defense procurement apparently will continue to increase at past rates.

Slower growth in investment--or even falling investment--will not have a sharp impact on economic growth in the near term. Even with reduced investment flows, the capital stock will continue to grow fairly rapidly for a time. But by the mid-1980s the investment decisions taken now are bound to reduce the growth of fixed capital in the economy considerably.

Foreign Trade

Until recently, the USSR also has been able to use foreign trade to offset some domestic shortfalls. Capitalizing on rising energy and gold prices as well as rising arms sales Soviet hard currency earnings reached a record $30 billion last year. As a result, Moscow was able to greatly increase its purchases from the West.

- o Net food imports climbed from roughly $5.5 billion in 1978 to an estimated $12.5 billion this year. Agricultural purchases now account for almost half of Soviet hard currency imports. Without this support the Soviet diet would have deteriorated seriously.
- o Imported steel--mainly specialty steels and large diameter steel pipe--has likewise offset shortfalls in domestic production. Deliveries totaled roughly 10 million tons in

1980--10 percent of Soviet production of rolled steel in that year.

- Purchases of equipment and tubular steel pipe from foreign suppliers have allowed stepped-up investment and exploitation of critical energy resources.

This year, however, Moscow's trade position has taken a turn for the worse. The combination of record high agricultural imports and a softening Western market for oil could double the trade deficit to $5 billion and leave Moscow with little if any surplus in its current account balance. Nor are the hard currency prospects bright in the immediate years ahead. Oil exports earnings will be squeezed by stagnant or falling production, rising domestic consumption, and--possibly--weak prices. The Siberian gas pipeline--the only potential large earner of foreign exchange--will not be fully operational until 1986 or 1987 at the earliest.

Some potential may exist for increasing arms sales (last year Moscow added $11 billion in new military contracts to its order books), but the export outlook for other Soviet products is much gloomier. Sales of civilian machinery and equipment for hard currency have plateaued and may in fact fall, while exports of wood, metals, and non-fuel minerals are expected to grow little if at all.

Consumer Welfare

The year 1981 marks the third consecutive year of increasing food shortages, mostly in the area of quality foods--meat and dairy products. Rationing of these items, mostly in the form of informal purchase limits, has become increasingly frequent and widespread since last winter. Factors other than the rather small drop in the per capita availability of food supplies, however, have forced the government to act: namely, large-scale diversions from the retail food network, the maintenance of fixed prices in state retail outlets, and growing demand generated by wage increases.

Whatever the cause of the shortages, the consumer's mood is generally one of pessimism and resigned acceptance. Although some work stoppages have occurred this year, Soviet workers are still a long way from venting their dissatisfaction as the Polish workers have. To diminish the potential for labor unrest, the leadership has allowed the proliferation of special food distribution systems. Once reserved largely for the Soviet elite, these systems have become common at the factory level. The encouragement of special food distribution, coupled with the traditional stoicism of the populace, has been enough to maintain labor peace. In effect, the leadership has shifted the worst burden of the food shortage to social groups like the elderly who are least likely to protest.

The most serious consequence of the slowing growth in consumer welfare from the leadership's point of view is its impact on labor productivity. We expect per capita consumption to stagnate during the mid-to-late 1980s. For a population that has enjoyed substantial improvement in living standards during the 1960s and 1970s, any interruption in these gains is likely to reduce worker motivation and hence productivity. The leadership is counting upon labor productivity gains to obtain 90 percent of the growth in industrial output and the entire growth in agricultural output in the current Five-Year Plan. Moscow thus faces a dilemma. It is relying upon a strategy of promoting efficiency and productivity throughout the economy rather than more investment to restore past rates of economic growth and boost consumer welfare. But unless the leadership provides sufficient increases in quality foods and goods now to a labor force less willing to defer material satisfactions to the future, we do not think this strategy will work.

Leadership Response

So far the leadership's response to growing economic difficulties has been cautious and conservative. We have seen for example, no sign of an effort to curb military outlays to boost the civilian economy. Physical indicators of future levels of defense spending--such as programs in training and investment in defense production and R&D facilities--point to continued real growth of about 4 percent per year. Nor has the Politburo taken any significant steps to change the system of planning and management to cope with the economic slowdown. The planners' main concession to the resource bind has been to cut investment growth during 1981-85 to the lowest rate in the postwar period.

The leadership clearly recognizes that the economic situation is serious; President Brezhnev has been sounding this theme since the late 1970s. Evidence of the leadership's rising concern is reflected in their attempt to impress the elite with the serious nature of the economy's problems. In August 1979 a high-level official of Gosplan was sent to address senior foreign ministry officials on "Problems of Economic Development." He candidly described the large drop in labor productivity and the shortage of capital and manpower. The gloomy nature of the discussion was unexpected and reportedly upset the audience. From December 1979 to February 1980 a series of meetings was held, this time for a group of 300 leading academicians of the Soviet Academy of Sciences. Senior government officials revealed that the economy was suffering "very serious problems" and in an unprecedented move asked for suggestions and advice.

Nonetheless, the leadership's reluctance to adopt new policies on resource allocation or economic organization also partly reflects a less pessimistic view of the economic situation than our own. They tend to believe that present policies designed to improve planning and stimulate technological progress will be successful eventually. In addition, Soviet leaders believe that some of their problems are transitory. They apparently believe, for example, that:

- o demographic trends will lead to an upturn in the labor supply in the 1990s;
- o better weather and greater efficiency will restore growth in farm output and help solve the food problem;
- o increased production of gas and conservation will more then offset any stagnation in oil production in the years ahead; and
- o new technological fixes and breakthroughs will improve economic performance and productivity.

More generally, they tend to make their economic assessments in comparative terms and may take some solace in the fact that the Western economies are also experiencing serious difficulties and challenges.

Perhaps the most important reason for the inertia in domestic economic policy, however, is the inability or unwillingness of the present ageing leadership to undertake decisive actions and fundamental reforms. The ruling group, knowing that its remaining tenure is limited, seems incapable of making the hard policy choices involved in shifting resource allocations, modifying administrative arrangements, and changing organizational structures. Such decisions would necessarily affect entrenched institutional interests and generate bureaucratic conflicts, and would be fraught with political uncertainties. Fundamental changes in economic policy thus must await a leadership that recognizes the economic risks of policy immobilism and that is more reform-minded than the present leaders.

Outlook for the Economy

The economic problems now facing the Soviets are for the most part familiar.

- Agriculture continues to suffer from chronic organizational inefficiencies and remains vulnerable to wide swings in performance because of climatic conditions.
- Investment has had difficulty in keeping up with an enormous, aging capital stock; hence, capital stock growth must necessarily slow.
- Growth in productivity has lost much of its steam as exhortations have lost their effectiveness and material incentives have been dulled by shortages of consumer goods and a buildup of excess savings.

While the problems are familiar, their intensity has increased--leaving the Politburo with less and less room for maneuver. In the 1960s and early 1970s, the Soviet leadership could satisfy a number of economic priorities simultaneously.

- Average living standards rose dramatically.
- Productive capacity increased rapidly in all sectors of the economy.
- Sustained growth in defense spending led to major qualitative improvements in weapons systems as well as an impressive expansion of military forces.

A multi-sided attack on priorities will no longer be possible in the 1980s. In this new environment, there will be some "losers," greatly complicating decision making.

- GNP growth may average less than 2 percent per year over the current decade.
- If defense spending continues to rise at about 4 percent per year, the defense share in increments to GNP could rise from about 1/4 now to 1/2 in the mid-1980s and to 2/3 by 1990.
- Slower growth in industry and steady growth in defense means much slower growth in investment and increasing tensions among regional interests.
- Sponsors of consumer-oriented programs will have increasingly less to work with, and those responsible for public order will have to worry more about the population's mood.

Whereas the present leadership is not disposed to undertake new policy initiatives, economic circumstances in the mid-to-late

1980s will to force the Soviet leadership then in power to decide anew on development priorities and--perhaps--on the need for economic reform.

Increasing Need for Western Support

Because of its economic difficulties, we think that the USSR will have an even greater need for Western goods in the 1980s. Specifically, Western imports could help alleviate:

- The Productivity Lag

  Imports of Western plant and equipment, though now only about 5 percent of total domestic investment, make a disproportionately large contribution as they are more productive than their Soviet-designed counterparts. Moreover, imports are concentrated in those sectors most crucial to technological progress--e.g., chemicals and machine building.

- Fuel Shortages

  Imported Western oil and gas equipment can help locate and explore the new oil and gas resources needed to offset depletion of the deposits now under production.

- Industrial Bottlenecks

  Steel shortages, for example, are hindering production of civilian machinery. Continued imports of steel would help counter the effects of inadequate Soviet investment in new steel capacity.

- **Pressure on Defense Spending**

  A continuation of high growth rates for defense despite the low economic growth rates projected for the 1980s will lead to an inevitable erosion of the civilian machine building sector. Imports of Western plant and equipment could bolster the civilian industrial base.

- **Consumer Welfare**

  Food imports, especially grain and meat, could be crucial to maintaining consumer morale and encouraging labor productivity during the 1980s.

Imports of Equipment and Technology

If the USSR were denied access to Western equipment and technology, the Soviets would be forced to go it alone, entailing major losses in product quality and labor productivity. Soviet leaders would most fear a decisive interruption in commerce because the USSR's scarce stock of resources could not be stretched to accommodate a sudden demand for import substitutes. They would especially want to avoid a curtailment of trade in the next several years because they believe that Soviet economic problems will be toughest in the short and medium-term. While a denial limited to US-origin equipment and technology would be disruptive in the short term, other Western and some East European equipment and technology provide adequate substitutes. A narrow group of items specific to oil and gas exploration and production, such as submersible pumps, represents a notable exception, but even here industry experts say that foreign replacements could be found within a few years.

Imports of Agricultural Products

Western imports are important to Soviet planners in supporting the growth in living standards necessary to raise worker morale and productivity. Even with normal harvests, Moscow will need to buy 20-30 million tons of grain annually for at least the next several years to support announced livestock expansion programs. If all Western suppliers were to suspend grain sales to the USSR, Moscow would be forced to take one or more of the following steps:

- reduce livestock herds to alleviate some of the pressure on feed supplies;
- expand rationing and other conservation measures;
- halt meat and grain exports to client states;
- draw down strategic grain reserves.

A partial grain embargo would have a much more limited effect. Moscow could buy most of the grain it needs from other suppliers, as it did after the post-Afghanistan embargo, although the USSR would have to pay premium prices for the grain and cope with port congestion.

The Role of Western Credits

But any increase in purchases of Western goods will depend primarily on Soviet ability to obtain hard currency credits and the terms on which these credits are granted. Thus, Moscow will have to rely more on gold sales and on Western borrowing if it is to avoid cutting imports of agricultural products or capital goods. Given its low debt-service ratio, Moscow should have little difficulty raising additional funds as long as credits are tied to imports and the political climate does not deteriorate greatly. The USSR, however, will want long-term credits at interest rates lower than those now prevailing in the West. Otherwise, the benefits of borrowing would be greatly diminished by a rapid build up of repayment obligations. Even under favorable circumstances the Soviet hard currency position will be extremely tight and Moscow's willingness to supply hard currency goods and assistance to its East European allies will be sorely tested.

Implications of the Economic Slowdown for Western Leverage

In summary, we judge that Soviet leaders will resist any threat of a Western embargo because they believe that:

- any response to such a threat would amount to appeasement and would undermine their position both internationally and domestically;
- their economic problems, while serious, are not cause for panic, and should begin to ease during the 1990s; and
- the damage caused by an embargo would not lead to domestic

turmoil. The Soviet population, in their view, has had to endure much worse hardships and if necessary could do so again.

Whatever the Soviet perceptions, a widespread, sustained embargo would cause substantial disruption and dislocation. Several major development projects would be seriously delayed, and Moscow would have to abandon its goals for consumption of livestock products. A partial embargo would not hurt the Soviet Union nearly as much, although measures as limited as administrative delays in approving equipment and technology exports would force plan adjustments. Politically, the Soviet leadership might respond by taking an even more aggressive stance internationally. They probably would see little positive incentive in restraining their behavior abroad and might believe that foreign adventurism could be used to rally support for economic sacrifices at home.